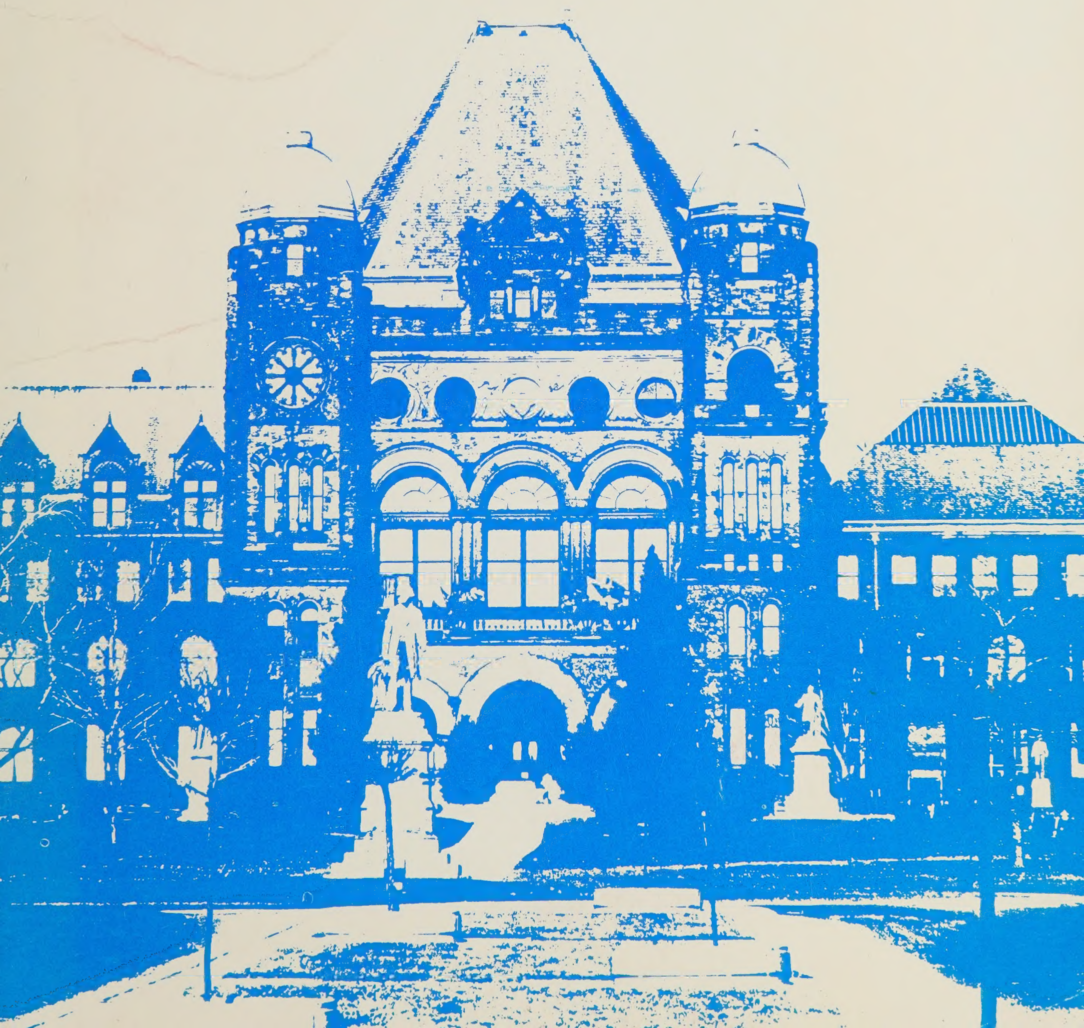
Ontario Proposals for Tax Reform in Canada II

# Tax Reform and Small Business

The Honourable Charles MacNaughton
Treasurer and Minister of Economics



Ontario Proposals for Tax Reform in Canada II

# TAX REFORM

# AND SMALL BUSINESS

ONTARIO

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## PREFACE

This is the second paper of the Ontario Government containing definite proposals for reform of the Canadian tax system. Since the first paper last June, the Committees of the House of Commons and Senate on the federal white paper have presented their reports. These reports constitute an important contribution to the current tax reform process.

The Ontario Government was happy to note the emphasis of both reports on the central importance of economic growth in tax reform and that tax reform must not impede savings and investment in Canada. The Ontario Government was also pleased to note the emphasis the Committees placed on achieving a national tax system which could be used by the provinces.

There were two main thrusts to the first *Ontario Proposals.* The first was effective comprehensive relief for low-income Canadians. The second was economic growth.

This paper deals only with the second of these thrusts – with its main emphasis on the appropriate taxation of small business in a tax context favourable to Canadian savings and investment. The paper proposes a new incentive to assist a very broad group of Canadians – those who risk their money and employ their energies to start and expand their own businesses – Canadian owner-operators. The Ontario Government believes that the incentive proposed would provide strong encouragement to expanded Canadian participation in the Canadian and world economy. It would do so by helping Canadians raise needed capital. It would not discriminate against foreign investment which will continue to play an important role in Canadian development.

The Ontario Government has advanced its studies on the taxation of small business to the point where it feels the results would now benefit from wider discussion. Accordingly, we invite comment and public discussion by interested taxpayers. We also invite the federal government to sit down with provincial governments and to discuss these and other reform proposals on a frank and open basis where all views are on the table. This is the only way to achieve a partnership approach in the final stages of settling the long-term tax structure for Canada and the provinces. The frankness of discussions between the provincial and federal governments must not be circumscribed by traditionally secret budget procedures which are unsuitable where major long-term changes are being made.

December, 1970

The Honourable Charles MacNaughton
*Treasurer of Ontario and Minister of Economics*

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# SUMMARY

This paper advances Ontario's proposals for a new small business incentive to replace the present dual corporate rate. This incentive is based on a limited tax credit to owner-operators as the best means of providing an incentive in the small business area.

The main features of this proposed incentive are:

- a tax credit for individuals of fifty per cent of increased investment in small business;
- tax credit not to exceed fifty per cent of personal income tax otherwise payable;
- subject to annual and lifetime dollar limits;
- restricted to Canadian residents who not only risk their own capital in either an incorporated or an unincorporated business but also pit their own efforts in making the business go;
- recovery of tax credits when the owner-operator disinvests; and
- rollover provisions to permit asset changes and to avoid lock-in effects.

The basic considerations leading to this proposal are outlined in Chapter 1. Chapter 2 compares the present Canadian tax system, the United States system and the federal white paper system in order to appraise how small business may best be encouraged. Chapter 3 develops the incentive. Chapter 4 outlines further possibilities in the small business and related areas. Chapter 5 explores the Ontario system, partly in relation to the comparison in Chapter 2, and partly in relation to the small business incentive proposed in Chapter 3. Finally, Chapter 6 summarizes our conclusions.

# 1 INTRODUCTION

Tax reform discussions have advanced considerably since the Ontario Government set out its general proposals for national tax reform in its paper *Ontario Proposals for Tax Reform in Canada.*[1] These developments confirm the thrust of the *Ontario Proposals* in their emphasis on economic growth as a central concern of tax reform.[2] The primary purpose of this paper is to expand upon the proposals for the taxation of small business contained in Chapter 6 of that paper. In addition, this paper will expand upon the related proposals affecting savings and investment in Canada. The proposals contained in this paper are properly to be considered as a further development of the basic national tax system contained in the *Ontario Proposals.*

## *1.1 Small Business Consensus*

The *Ontario Proposals* reflected the profound concern of the Ontario Government about the possible effects of the federal white paper proposals on small business in Canada.[3] This widely-shared concern was expressed in the submissions of many taxpayers and other provincial governments, and resulted in the announcement by the federal Minister of Finance of the appointment of a federal civil service committee to study and recommend appropriate measures designed to strengthen the role of small business in Canadian life. It was further reflected in the subsequent reports on the federal proposals by the Senate and Commons Committees.[4,5]

There is clearly a broad consensus in Canada that small businesses require taxing arrangements favourable to their development and growth. There is virtual unanimity that the federal proposal to abolish the lower rate of corporate tax on the first $35,000 of taxable income without offering any effective alternative is too harsh and that it would be damaging to small business, both by itself and in conjunction with other proposals in the federal white paper. The question is thus not *whether* the original federal proposals should be changed but only *what* should be done and *how.*[6]

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[1] Hon. Charles MacNaughton, *Ontario Proposals for Tax Reform in Canada,* (Toronto: Department of Treasury and Economics, June, 1970); hereinafter cited as the *Ontario Proposals.*

[2] The *Ontario Proposals* made it clear that the other major concern was comprehensive tax relief for low-income Canadians.

[3] Hon. E.J. Benson, *Proposals for Tax Reform,* (Ottawa: Queen's Printer, 1969); hereinafter cited as the federal white paper.

[4] The Standing Senate Committee on Banking. Trade & Commerce, *Report on the White Paper Proposals for Tax Reform,* (Ottawa: Queen's Printer, September, 1970); hereinafter cited as the Senate Report.

[5] *Eighteenth Report of the Standing Committee on Finance, Trade & Economic Affairs respecting the White Paper on Tax Reform,* (Ottawa: Queen's Printer, October, 1970); hereinafter cited as the Commons Report.

[6] In the light of this consensus, it is interesting to note the comments of the Carter Report respecting withdrawal of the lower corporate rate: "[W]e believe it would be unwise to recommend withdrawal of the low corporate rate without making some adjustment within the tax system designed specifically to assist new and small businesses." *Report of the Royal Commission on Taxation,* (Ottawa: Queen's Printer, 1966). Volume 4, page 277.

### 1.2 Broad Benefits of Small Business

The reasons *why* something should be done are important in deciding *what* should be done. For example, if the only aim is to offset an alleged lack of "neutrality" in the market place in the raising of capital for small business, any special small business provisions should be designed with this in mind. On the other hand, if the objective is the more practical one of encouraging certain types of activity, a rather different approach will be more appropriate.

Tax incentives are not the only means of assisting small businesses. A very extensive range of incentives is already provided by both the federal and provincial governments outside the tax system. These include market supports, grants, loans, guarantees and a variety of business related services. Many of these incentives help small businesses but are not restricted to them. Rather, they are designed to achieve selective objectives whether related to a particular industry as with the grants payable under the federal Defence Industry Productivity Program, or to regional development as under the Ontario Equalization of Industrial Opportunity Program.

The position of the Ontario Government is that broad social and economic benefits flow from the effective encouragement of small businesses through the tax system. Many of the reasons are described in the *Ontario Proposals.*[7] Accordingly, this paper will consider the best means of utilizing the tax system for fostering a climate or environment of opportunity to which individual Canadians will respond with their own initiative and enterprise.

### 1.3 Keep Dual Rate until Replaced by Strong Incentive

The position of the Ontario Government is to retain the present dual rate of corporate tax for small business until a new strong incentive is in place.[8] This is in some respects similar to the position of the Commons report which suggests, as a minimum, an approach which seems to involve something like a dual rate. However, that report also suggests that alternative proposals (such as a capital formation tax credit) which might prove more effective in the longer run should be studied.[9] The Senate report recommends retention of the lower rate and offers a method of restricting it to smaller businesses.[10]

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[7] See, beginning of Chapter 6 of the *Ontario Proposals.* Similar reasons were given for the continuing importance of small businesses in the United States. See, The President's Task Force, *Improving the Prospects of Small Business,* (Washington: U.S. Government Printing Office, 1970).

[8] *Ontario Proposals, op. cit.,* page 33.

[9] *Commons Report, op. cit.,* pages 52 and 53.

[10] *Senate Report, op. cit.,* page 65.

This paper will assess the validity of retaining a dual corporate rate on some more appropriate basis. It will also explore the possibility of an effective alternative which will achieve more benefits for the economy at a reasonable cost in revenue. One reason why the Ontario Government favours a strong incentive to Canadians to acquire, develop and expand new and small businesses is because lasting revenue increases can only flow from an efficient and dynamic economy created by individuals who respond to an environment of incentive and opportunity.

### *1.4 Taxation and Small Business Dynamics*

While the federal white paper proposal to eliminate the dual corporate rate generated the greatest amount of concern in public discussion, there are several other important general features of the tax system which can affect both the incentive and ability of Canadians to start a new business or acquire and expand an existing business. All must be taken into account.

Taxation must be viewed in a dynamic context and must recognize the motivations and financial capacities of those affected. The fact that income taxes are normally collected on the basis of a single year does not mean that tax policies should be similarly circumscribed. Successful businesses can take a long time to build. Taxation must recognize this if the building-up process is not to be seriously impeded. It is too restricted a view of ability-to-pay to regard funds surplus to the needs for productive investment and funds tied up in productive investment as always equally available to pay taxes. This is an essential point in designing taxes which will permit and encourage the growth of the small business sector of the economy.

People's motives in starting or running their own business vary, but they usually include two elements: the greater personal fulfillment in creating or running one's own business; and the hope of building up something permanent – which may provide retirement income, or capital for some other purpose or to leave to one's heirs. Such motivations are not primarily directed at earning slightly more in current income in a particular year. Generally, it is the ability to retain earnings for expansion and to hold on to a reasonable part of what one has built up which is important to the small businessman. Taxation which affects either of these factors can have important effects on the commencement, development and expansion of small business. What is required is greater awareness of the concrete effects of different taxation arrangements on small business in a dynamic sense over the life of the business and the businessman.

### *1.5 Primary Importance of Effects on Savings and Investment*

The Ontario Government approach is that the general savings and investment effects of taxation are of primary importance, to be dealt with in the first instance on a very broad basis related to national goals. These goals include the efficient growth of the economy, the provision of jobs, the control of inflation and the encouragement of Canadian savings. [11] Any tax encouragement of small business should fit sensibly and easily into the general taxation arrangements. But specific tax arrangements cannot make up for inadequate or unwise general arrangements.

The savings and investment approach outlined in the *Ontario Proposals* involved two main elements:

- general taxing provisions favourable to savings and investment which would be applicable to all business; and

- additional special savings and investment promoting taxing arrangements which would be available *only* to individual Canadian residents.[12]

These special arrangements for individual Canadians were also proposed as a means of promoting two other important national objectives:

- increased Canadian ownership in profitable business; and

- broadened economic democracy by making it easier than it is today for more people to save and invest in Canadian enterprise, and so to participate more fully in the economic opportunities of Canada.

### *1.6 Principles of Ontario Approach to Savings and Investment*

The investment and savings approach of the Ontario Government reflects two main principles:

- *Current income differs from capital as a source of future income.* Many unnecessary and undesirable problems flow from a failure to recognize this difference in taxation. Current taxation of income and consumption is appropriate because most taxpayers can adapt to reasonable changes on a current basis – by working more, seeking higher incomes or reducing expenditures. On the other hand, a lifetime basis for taxing capital is generally preferable so long as

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[11] *Commons Report, op. cit.*, pages 8 and 9.

[12] *Ontario Proposals, op. cit.*, pages 21, 25 and 33.

it remains such and is not diverted into the current consumption stream. Capital investment usually represents the results of the efforts of many years or decades, and is frequently committed for many years into the future. This greatly reduces the degree of taxpayer adaptability in the short run. To the extent that such a lifetime basis of taxing capital is adopted – be it by capital gains or estate taxation – it will lend strong support to particular measures to promote small business, as well as bigger business, in the hands of Canadians.

- *The primary taxation arrangements should provide a framework of opportunity that leaves individuals free to respond in a very broad way as they see fit.* This does not preclude more selective measures inside or outside the tax system, for the achievement of more particular ends. However, it precludes as the primary arrangement the use of taxation, subsidies or loans in a very specific way, since this could introduce a much higher degree of government intervention and direction of activity than is sound for widely applicable measures.

### *1.7 Approach of this Paper*

Our studies make it clear that there are a variety of small business and related investment options open to policy makers, each with advantages and disadvantages. There are no proposals without disadvantages. Disadvantages, however, must be assessed against the probable gains. Thus, an awareness of the alternatives available is necessary to place any particular proposal in proper perspective. There are no ideal solutions, and a preoccupation with ideal solutions will likely prevent adoption of practical ones.[13]

This lively awareness of alternatives underlies the approach in this paper. Within this approach, the first step is to establish the tax context in which small business is expected to operate. The second step is to identify the key concepts which should guide the particular small business tax arrangements adopted. Only then is it possible to explore the best mechanics or taxation devices to give effect to the guiding concepts which have been accepted. This presupposes identifying what we are trying to achieve in a practical way, before proposing the taxation mechanics to achieve it.

### *1.8 New Small Business Tax Incentive*

After careful study of the alternatives, and the benefits to Canada of a new strong incentive to new and small business, this paper will propose for serious consideration a fresh approach based on abolition of the dual corporate rate. It has a number of novel features:

[13] The Commons Committee arrived at a similar conclusion. *Commons Report, op. cit.*, page 8.

- only individual Canadian owner-operators would qualify for the incentive;

- the maximum annual amount of the incentive available to an owner-operator would be comparable to the maximum annual benefit now available through the lower corporate rate, but would be dependent upon new or increased investment in unincorporated or incorporated business;

- the incentive would be ultimately recoverable in a manner which should not interfere with sound business decisions or the effectiveness or fairness of the incentive; and

- annual and lifetime limits on the total amount of incentive available to any one person should ensure fairness and administrative workability.

The choice of the Canadian owner-operator as the person to get the incentive means that not every business or investor would benefit. But far more Canadians would benefit than under the present lower corporate rate. Every small business, whether or not incorporated, could benefit. It would help Canadians to start or acquire a business more easily than the present system. It would enable them to join together in business without loss of tax benefits as at present. Passive investors, large corporations and non-residents would no longer benefit. The only Canadian owner-operators today who would benefit less are those whose initial or expanded investment is insufficient to take full advantage of the incentive. Finally, after introduction of the new system, every Canadian who invests as an owner-operator would be entitled to earn precisely the same lifetime credit as every other Canadian.

### *1.9 Incentive Strong but Not Unlimited*

The incentive would be strong but it would not be unlimited. Being a Canadian owner-operator would not be enough. Investment in the business would also be required. Similarly, investment in the business would not be enough – one must also be a Canadian owner-operator. Not only would there be a limit to the total amount of incentive available to any Canadian, but once in every lifetime the amount received would be fully or partially recovered to the extent the business is successful. And quite apart from recovery, every recipient would have to pay at least as much in annual taxes as he receives in annual tax deferrals. In a real sense, the success of those helped by the incentive would in turn provide revenues to help new Canadian owner-operators to succeed for their own benefit and the benefit of Canada.

The proposed small business incentive is expected to work relatively simply in the vast majority of cases. However, the variety of business arrangements and the predilection of some taxpayers to seek undue advantage of any favourable taxation arrangements mean that a measure of complexity is necessary for the special cases. It is anticipated that the main increase in complexity from tax reform – assuming integration does not replace the present dividend tax credit system – would come from the introduction of capital gains taxation. The administrative features of the proposed incentive should fit reasonably easily into the administrative requirements of capital gains taxation.

### *1.10 Full Consideration Important*

The owner-operator incentive is proposed because it is felt it is workable and would encourage significant response from Canadians. While it is only a proposal, the Ontario Government believes it merits serious consideration in terms of its potential for promoting simultaneously a number of important goals. As a novel proposal, there may be insufficient time to assess it in a deliberate and careful manner and have it ready for implementation by the tax reform target date of January 1, 1972. If this turns out to be the case, the dual corporate rate should be retained for one further year.

The novel aspects of the proposal and the fact that there is no experience from which taxpayer response and revenue impact can be accurately determined in advance make full discussion even more important than usual. A number of the specific features, such as the businesses to be included and excluded, the proposed annual and lifetime dollar limits and the manner and extent of ultimate recovery, are advanced as reasonable starting points for discussion and are certainly open to modification. Further, if the plan were implemented it would be desirable after a few years of operation to review the nature of the response to determine how effectively the incentive is working in relation to the objectives sought.

The proposal is advanced as a long-term encouragement to the development of the Canadian economy by Canadians, and must be considered in this light. At the same time, it has the important merit of not discriminating against foreign investment. Canada will continue to need foreign investment in the foreseeable future if widely accepted goals are to be achieved.

A detailed technical study of the proposals advanced in this paper has been prepared in the Department of Treasury and Economics, Taxation and Fiscal Policy Branch. The study contains particulars of the operation of the proposed small business incentive in a variety of circumstances, with arithmetical examples. It also contains arithmetical comparisons between alternative tax systems. This study should assist in the consideration of the desirability and workability of the proposed small business incentive.

# 2 THE PRESENT SYSTEM AND THE FEDERAL WHITE PAPER PROPOSALS

The Ontario Government approach stresses attention to all tax burdens in order to assess their appropriateness in relation to tax reform objectives. It also emphasizes the importance of economic growth. Now is not an appropriate time to introduce new tax burdens which will make economic growth more difficult to achieve. This chapter compares the present Canadian tax system, the present United States tax system and the federal white paper system in order to appraise how Canadian small business may be best encouraged to develop and grow under a reformed Canadian tax system. This comparison will provide an essential basis for assessing the system proposed by the Ontario Government for small business taxation.

## *2.1 Present Canadian System*

In general, the present system (ignoring the 1968 estate and gift tax changes)[1] constitutes a strong incentive to create and expand new businesses and to retain earnings for investment rather than distribute them. While estate taxes (but not gift taxes) have been reasonably heavy, estate planning has often been able to reduce their burden or spread the period of their impact. Further, the absence of a capital gains tax and the generally lower rates of corporate tax in comparison with high marginal personal tax rates have generally encouraged retention of earnings in a business while it was being built up.

A Canadian starting a business under the present system is in roughly the following position. There is no individual tax concession in respect of any initial business investment. If an individual's business is incorporated, the first $35,000 of annual taxable income after salaries and bonuses can be retained in the business at about $10,000 annual saving of corporate tax by virtue of the lower corporate rate being applicable to this level of income. This saving can be lost, however, and the high corporate rate applied to all earnings in some circumstances – if the corporation has other shareholders who are also shareholders of other companies, or if the individual is a shareholder in another company, and the technicalities of the shareholder relationships are such as to give rise to the company being associated with one of these other companies.[2]

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[1] A fair assessment of the impact of tax reform on small business requires a comparison of the Canadian tax system before any reform and the complete reformed system. Accordingly, we refer to "present Canadian system" as the system in effect before the estate and gift tax changes. We refer to the white paper system as including these estate and gift tax changes as part of the federal proposals for tax reform.

[2] This is the associated corporation problem referred to in the white paper (paragraphs 4.16 and 4.17). While the federal white paper stresses the undoubted abuse of the lower rate by some taxpayers who until 1963 avoided the rules designed to limit the advantage, it does not refer to the restrictive effect of these same rules on normal business arrangements.

High personal tax rates encourage retention of earnings above $35,000 in many cases, because the corporate rate is less than the personal rate. Most important, however, capital gains are tax-free, so that going public[3] or selling out does not result in any tax. Difficulties arise in estate planning in connection with corporate surplus and estate taxation – the potential combined impact of two taxes at death. While estate planning can frequently modify the impact, it is generally agreed that any tax reform should face this issue head on. Whatever is proposed should deal with the question at death, and not attempt palliative measures like deferring the tax impact past the death of the owner.[4]

The principal advantages of the present system are thus encouragement of retention of earnings for growth and the tax-free treatment of any gains in the capital value of the business. Going public, for example, as a natural stage in the history of an expanding business, creates no tax problems and may even alleviate some. These are strong incentives, and their merit as such was only partially negated by the problems associated with the taxation of corporate surplus and estates.

The lower rate of corporate tax has certain disadvantages, even from the standpoint of small business:

- the restrictions of associated company status;
- the need in most cases that there be profits from the new business itself;
- it does not extend to unincorporated business; and
- it does not begin to provide any significant tax relief until personal incomes exceed about $10,000 and becomes proportionately more valuable as individual incomes increase.

Nonetheless, the present balance – the dual corporate rate, high graduated personal tax rates and the taxation of corporate income in the hands of corporations and of dividend income in the hands of shareholders – is a stable one which fosters retained earnings in businesses. Any instability in the present system which surrounds the corporate surplus problem arises principally from two elements which could be readily corrected:

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[3] "Going public" is the process whereby a corporation previously owned by one shareholder or a small number of shareholders becomes owned by many shareholders (the public) who do not form a particular group.

[4] This unsatisfactory approach was adopted in the federal white paper by providing a rollover at death, but without eliminating potential gains tax subsequent to death by increasing the cost basis to heirs to the fair value on which estate tax is paid as is done in the United States.

- the absence of sensible tax-free corporate reorganization provisions combined with the "sledgehammer effect" of the designated surplus provisions;[5] and,

- the failure to deal directly with the appropriate relationship between the possible taxation of corporate surplus at death and the level of estate taxation.

### *2.2 United States System*

The United States tax system provides similar incentives toward retained earnings by small business. While the maximum annual per company savings are less than in Canada at present, at about $6,500, it is generally easier to qualify a *new* or *different* business in order to get the same benefit more than once. The capital gains aspect is less favourable, at least in principle, while the weight of estate and gift tax is generally comparable. However, United States capital gains tax may be avoided completely by tax-free rollovers[6] to a higher cost basis in the hands of heirs on death, or to the same cost basis by an exchange of shares of the small business corporation for shares of an acquiring company. A combination of both rollovers may be used: first, by selling out in exchange for the stock of a public company, and then by holding that stock to death, at which time it can be sold free of capital gains taxation on the increased value accrued to the date of death. In practice, therefore, despite the existence of a capital gains tax, and a lower rate of tax on only the first $25,000 of a corporation's income, the present position of the small businessman in the United States is not significantly less favourable than in Canada.

### *2.3 White Paper System*

When it comes to the federal white paper system, including the estate and gift tax changes of 1968, small business is transported into a radically different and harsher world. Gone are the factors which encourage retained earnings. Not only is the favourable treatment of capital gains gone, but there is also the harsher ultimate taxation of capital on the deaths of parents and the much restricted opportunities to ameliorate that impact through estate planning. Both building up and retaining the business become much more difficult. Only wealthy owners of businesses which are not worth more than their book value and do not need retained earnings to grow would benefit from full corporate – personal income tax integration and a top 50 per cent personal income tax rate. They could avoid any capital gains tax and would pay substantially lower annual taxes than at present on fully distributed earnings. By contrast, the sale of a company while closely-held which is

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[5] Corporate reorganization is a general term that refers to a variety of different legal means whereby businesses under common ownership are rearranged by consolidation under a common corporate roof or by separation under separate corporate roofs. The essence is that there be no change of ultimate ownership as a result of the reorganization, although the reorganization itself may precede or follow such a change.

[6] A rollover arises where one asset is substituted for another in a transaction in which any gain or loss is not recognized for tax purposes.

valued for its growth potential rather than retained earnings would result in capital gains taxation at 50 per cent, or at 25 per cent as part of going public. In the latter case, there would also be the continuing five-year revaluation rule requiring payment of capital gains tax on any shares retained after going public. This is in addition to substantially heavier estate taxation and elimination of the lower corporate rate.

The combined impact of the federal tax reform program represents a much harsher treatment of smaller business than either the present Canadian system or the United States system. The situations where the federal proposals are significantly harsher include starting a business and then selling it at a capital gain; or going public with it; or dying with an accrued capital gain from the business which must then be realized, either to pay the estate taxes or for some other reason such as a partnership buy-sell arrangement or the need for new management or more capital.

### *2.4 Present Balance Hurt by Federal Proposals*

On balance, the present Canadian tax system has probably been more favourable to the creation and expansion of new small business than that in the United States. Of course, the business earnings and capital gains prospects in the United States tend to be greater than in Canada because of the larger markets and higher levels of income and wealth in the United States. At the same time, the effect of the present Canadian tax system has not been so favourable as to promote private savings in Canadian hands in sufficient volume to eliminate the need for foreign investment or to enable Canadians to compete successfully with non-residents in all cases for ownership of Canadian business. It is hard to see how shifting the Canadian tax balance in a manner adverse to private savings by Canadians can avoid worsening the present international balance of ownership and control.

In contrast to both the present Canadian and United States tax systems, the essence of the federal white paper approach is to trade significantly lower taxation of current income distributed to shareholders for harsher annual income taxation of retained earnings (up to the first $35,000 of annual corporate income) and higher taxation of built-up or accumulated capital of the small business.

The Ontario Government rejects this thrust as inappropriate, not only for small business, but for the whole Canadian economy as well. This rejection was virtually unanimous in every respect in the private submissions to the Commons and Senate Committees and provincial statements on the federal white paper. Finally this rejection was fully supported by the reports of both the Commons and Senate Committees.

# 3 ONTARIO'S SMALL BUSINESS INCENTIVE

The Ontario tax reform emphasis is one of encouragement of capital investment and retained business earnings for reinvestment. The designing of an effective small business incentive is approached in this context, having regard to the motivations and financial abilities of those affected. Moreover, as there are broad reasons for special small business tax arrangements, the approach must be suitably broad if the desired effects are to be achieved.

The characteristics of a new small business incentive must promote the objective of an environment of economic opportunity for more and more Canadians. At the same time, it is important that the incentive be understandable, capable of reasonable and evenhanded administration, responsible in terms of revenue impact, and fair in its availability and in relation to the treatment of other taxpayers who also respond to the needs of the economy. In principle, every Canadian who wants to get into his own business, whether alone or with other Canadians, and who requires capital to do so, should be helped.

## *3.1 Six Basic Questions*

There are six basic questions, the answers to which will determine the form and amount of any incentive based on these principles:

- who or what should qualify?
- what is the basis of getting the incentive?
- should the incentive apply at the individual or corporate levels, or both?
- what limits should be imposed?
- should there be total or partial recovery of the incentive in specified events?
- should there be one incentive or more than one?

A consideration of the six basic questions has led the Ontario Government to advance as its preferred approach, a specific small business incentive based on two fundamentals:

- the only taxpayers to benefit will be individual Canadian resident owner-operators of businesses; and,
- the tax benefit will be directly related to increased investment in businesses.

A number of other features are proposed, but it is the above two features which the Ontario Government regards as basic to an effective small business incentive to replace the lower rate on the first $35,000 of income of a corporation.

### 3.2 Main Incentive Features

The following are the main features of the proposed incentive:

- *available only to individual Canadian owner-operators; not to non-residents, passive investors or corporations.* An owner-operator is that individual who combines his own capital and efforts to run his own business, alone or with others.

- *both incorporated and unincorporated business would benefit.* This would be achieved by making the incentive available to the individual only. There would be no reduction in the tax payable by the corporation.

- *incentive would be related to increased business investment.*

- *incentive would be the equivalent of an individual tax credit equal to 50 per cent of increased business investment.*

- *tax reduction in any one year would be limited to 50 per cent of the personal tax otherwise payable.* In this way annual individual taxes paid would be at least equal to annual tax savings achieved.

- *increased business investment which resulted in a higher tax credit than could be taken in the year of investment could be carried back one year and forward indefinitely.*

- *use of the tax credit approach would permit substantially the same proportionate value for high and low-income earners.*

- *annual and lifetime limits on the value of the incentive, say $10,000 a year or $100,000 a lifetime.*

- *property investments, portfolio securities and mining and oil and gas investments would not qualify.*

- *incentive would be recovered fully or partially on death or permanent emigration and on disposition or withdrawal of investment.*

- *reasonable rollover provisions related to reinvestment to avoid lock-in effects*[1] *arising because of the recovery principle.*

It is believed that the above features would together provide a balanced and workable system. The individual owner-operator and business investment tests would require that real things happen in the economy, before any incentive benefit could be claimed. These are the real things intended to be encouraged, and only if they were done would there be any incentive benefit. There would be no advantage or disadvantage between incorporating or not incorporating, or between differing corporate structures or shareholdings. The provisions of annual and lifetime limits and ultimate recovery would further reduce the likelihood of attempts to manipulate for the tax advantage. They would also reduce any benefit of doing so.

An incentive given to individual Canadian resident owner-operators cannot be said to be discriminatory in international savings or investment. It would facilitate the raising of capital by Canadian owner-operators but would impose no restrictions on where it was used. Indeed, because of the importance of increasing Canadian-based and owned business involvement in the world economy, Canadian resident owner-operator activity outside Canada would qualify. In many cases, especially in the expanding service business, outside Canada may be the most appropriate place for expansion.

The position of this paper is that it is a certain type of businessman – the Canadian owner-operator – who should get the incentive. The person to be encouraged is the person who risks his own capital and credit and pits his own efforts to make a business grow. With very few exceptions indeed, a business may be regarded as a small business if it is, by and large, financed and operated by the same people. A small business is thus best described as a business which is a person's own business, either alone or along with other people.

If this approach were adopted, passive investors in a small business would not themselves benefit, as they can now. They would be treated like all other investors. Equally, a small business in which the investors were one group, and the professional managers another group, would fail to qualify. It follows that going public would not be impeded so long as the outside share interest did not become so great as to result in Canadian owner-operators losing control.

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[1] Lock-in arises where a taxpayer prefers to continue to hold an asset rather than pay tax on disposal.

### *3.3 Wide Flexibility for Owner-Operators*

This basic balance of the proposed incentive, in terms of administrative and revenue considerations, should permit the other features of the incentive to be flexible. In this way, individual Canadian owner-operators could respond in the manner most suitable to them from a business point of view. As proposed, there could be wide flexibility for Canadian owner-operators:

- almost unlimited freedom to join together with other Canadian owner-operators without tax penalty;
- significant, although not unlimited, freedom to permit non-owner-operators to contribute capital to the business without tax penalty;
- unlimited freedom to grow without tax penalty;
- ability to apply tax reduction privilege against income from other sources, including employment income;
- funds to acquire existing business and every kind of tangible and intangible assets can qualify;
- investments could be timed on a business basis; and
- freedom to incorporate, join a partnership, or operate as a proprietorship, with no tax penalty.

The proposed incentive would in some respects be less broad than the present system:

- it would not apply to all corporations or types of business;
- it would be recoverable, if the owner-operator were successful, although only on disposition or withdrawal, or permanent emigration or death;
- an individual could not get multiple tax benefits through use of more than one corporation;
- large companies, passive investors and non-residents would get no benefits; and
- earnings would not be enough, there must also be business investment.

However, none of these limiting features should reduce the effectiveness of the encouragement to Canadian owner-operators to acquire and expand their businesses. Rather, they should reduce revenue losses and increase fairness by ensuring that the incentive goes to those Canadians who are intended to respond to it.

### *3.4 Entrepreneurial Capital*

It is generally recognized that entrepreneurial ability is scarce, not only in Canada, but everywhere. The Watkins Report found that Canada was not rich in entrepreneurial and managerial talent (the owner-operator sort of person) and that there has been in Canada a less open and mobile society than is consistent with optimal development of Canadian entrepreneurship. Its report also suggested that if there is any gap in the Canadian financial system, it is "entrepreneurial capital" – capital allied with human skills actively used in developing and managing the enterprise in which it is invested.[2]

Should the broad approach to encouraging owner-operators be extended to those who provide entrepreneurial capital but do not meet the owner-operator test? Is there a category other than the owner-operator and the passive investor which deserves attention as part of a small business incentive? This type of capital is related to launching new things – and if new things in general, or in particular, are also to be encouraged, it would seem preferable to approach this on a separate basis, because the principles and purposes will be different. Of course, the general structure of the tax system will be particularly important for entrepreneurial capital mobility. As entrepreneurial capital is scarce, it seems important that it not get frozen into investments that cease to be entrepreneurial, simply because the tax cost of switching is too high. This question is separate from, although not unrelated to, the issue of incentives to small businesses.

### *3.5 Size or Newness Test*

A size or newness test would narrow the scope of the incentive by excluding those owner-operators whose businesses grew too much or were no longer new. As growth is desired, it is important not to penalize those who succeed in growing. Moreover, it is important to encourage owner-operators to maintain and expand existing businesses as well as to create new businesses.

A newness test would be difficult to apply. It would also favour businesses which changed by revolution or came out of nowhere – a single identifiable step immediately recognized as new – in contrast to those businesses which were in a state of constant change by evolution, where one could never say at any one moment that a new business had been created.

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[2] Report of the Task Force, *Foreign Ownership and the Structure of Canadian Industry*, (Ottawa: Queen's Printer, 1968).

One important practical disadvantage of a size test is that, if it is based on income, it either involves very high marginal rates of tax as the business grows into the cut-off area or else the cut-off is smoothed over such an income range that all but the largest corporations would continue to benefit from the lower rate.

The Commons Committee proposal of a disappearing incentive would impose a tax of 66.3 per cent on the first $70,000 of income above $35,000, while the Senate Committee proposals would entail a tax rate of 100 per cent on the first $21,150 of income above $100,000. These high rates would penalize success and encourage tax manipulation to keep income down in order to avoid them.

Another disadvantage of the size of business test is that it runs counter to desirable mergers designed to increase efficiency through increased scale of operations.[3] This is unfortunate, as smaller scale in Canada is frequently cited as an important factor in the lower productivity of some Canadian industry in relation to United States industry. In the absence of other tests, choosing a size of business test will result in part of the benefit going to passive investors, large corporations or non-residents who were shareholders in a corporation receiving the lower rate or other incentive.

### *3.6 Basis of Getting Incentive*

The position of the Ontario proposals is that the incentive should promote economic growth and efficiency by Canadians through limited tax credits or deferments related to increased business investment in qualified assets. Thus, if there is no such increased investment, there would be no tax relief from the incentive, even though the Canadian owner-operator qualified as such.

An incentive related only to business earnings does nothing for the business which one might argue needs it most – the business suffering losses or not yet profitable. While it has the merit of being success related, it may jeopardize success, by not becoming available early enough in the life of a business. An investment-related approach at the individual level opens up two possibilities. First, if there is other personal income, the increased investment can qualify for a tax reduction on that other income even before the business earns income. Second, even where there is insufficient other personal income, a carry-forward provision ensures getting tax deductions as soon as income does develop.

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[3] If four owner-operators each had a business of the maximum qualifying size, then however sensible it might be for them to join together, the tax cost would be $30,000 a year under the present system and $40,000 a year under the Senate or Commons Committee proposals. This would constitute a heavy penalty for joining together.

A lower tax rate on small business income which is unrelated to investment is unquestionably a meaningful incentive. However, an open-ended forever incentive will almost certainly lead to a need for more stringent and complicated controls, such as the present associated corporation provisions and a size test. Yet these provisions penalize sound mergers and partnerships. Any requirement that the business stay small is contrary to the growth encouragement intended. Moreover, an incentive which only goes to Canadian owner-operators in respect of business investment is likely to achieve more by way of desired results in relation to revenue loss.

Since the incentive would be related to investment in real business assets, what assets should qualify? In the first place, mining and oil and gas investments (that is, investments qualifying for fast write-off or depletion) would be excluded as already covered by special industry rules. In the case of a property investment company, the appropriate level of capital cost allowance is the proper question to be decided. If something more is needed, an investment credit is a more appropriate approach. Again, portfolio-type investments in bonds, mortgages and shares would not qualify, as being appropriately the subject of general rules relating to the taxation of income and gains from such investments. Further consideration may disclose other types of activity which should also be excluded. Apart from these exclusions, bona fide investment in every other kind of business asset should be permitted as most consistent with the purposes of the incentive. The source of investment funds should be largely immaterial, and borrowed money or personal guarantees in respect of borrowed money should normally qualify.

### *3.7 Individual or Corporate Level*

The great merit of the lower rate of tax at the corporate level is that, at least in principle, it is relatively simple to administer and understand. The associated corporation problem has been the principal source of administrative difficulties. There are, nonetheless, a number of disadvantages of a corporate level incentive, some of which have already been alluded to:

- without size criteria, large corporations benefit and without an ownership test, non-residents benefit;
- with size criteria, growth is penalized and manipulation encouraged;
- it can be relatively inflexible, with natural business arrangements penalized on the one hand while unnatural business arrangements are encouraged on the other;
- the incentive cannot be used to reduce tax on other personal income during periods of little business income or business losses;

- distinguishing between corporations has been universally rejected in the case of the federal proposal for a closely-held widely-held distinction. Similar problems will inevitably arise in attempts to distinguish between corporations for the purpose of qualifying for the lower rate; and

- it does not apply equally to the incorporated and unincorporated business, and benefits high-income taxpayers proportionately more than low-income taxpayers.

The point about individual owner-operator business investment is that it is real. Corporations are essentially artificial and can be manipulated and multiplied in a fashion not necessarily related to real business activity. This is not possible with individuals and is difficult to achieve with investment in business assets. Moreover, a size test based on income is more easily met artificially than a test related to investment. It is easier to keep corporate income down than to get business investment up, in addition to being the opposite of what is desired.

### *3.8 Amounts and Limits of Incentive*

The approximate value of the present low rate of tax to a one-man business corporation earning at least $35,000 a year and reinvesting those earnings in growth is $10,000 per year. Accordingly, it is proposed that the maximum incentive per year for any individual owner-operator could be the same, but in the revised form of a tax credit equal to one-half of increased qualified investments. By using a tax credit, the proportionate amount of tax benefit available to individuals will be unaffected by the level of their personal income. The timing of tax credit deductions would be affected by the requirement that there be a maximum credit in any one year of 50 per cent of the personal tax otherwise payable in that year.[4] Moreover, every owner-operator would face the same lifetime limit on the maximum dollar value of the incentive.

If one-half of the amount of increased qualified investment exceeded the amount of tax credit which could be taken in a particular year, the unused portion of the increased investment could be carried back one year and carried forward indefinitely. It could be utilized for tax credits as quickly as possible within the limit of not more than a 50 per cent reduction in tax in any one year. In this way, timing of investments could be made in response to business and not tax considerations.

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[4] Only personal income tax would qualify for reduction. Capital gains under the Ontario Proposals are to be taxed under a separate plan without reference to personal income taxation.

Under the Senate and Commons proposals, as well as the present system, a one-man company earning exactly $35,000 in business income a year could do so forever, without a dollar increase in investment, and still save $10,000 annual corporate tax. It seems likely that this open-ended low rate is unnecessarily costly in relation to the objectives set. If there were a $100,000 lifetime limit – a difficult concept with a corporation, which would presumably require a new business test of some kind – it would mean a $200,000 qualified investment in the business. If four owner-operators joined together, it could mean building up to $800,000 qualified investment in a business over a ten-year period. In any event, the limits which are established would require review from time to time to ensure they were appropriate to changed conditions.

An individual owner-operator should be reasonably well established at a $200,000 qualified investment and be in a position to raise funds for expansion on the same basis as others. From that point on, it will be the general tax climate which will be of paramount importance. As mentioned previously, the specific small business arrangements should not have to compensate for inappropriate rules relating to savings and investment generally.

### *3.9 Recovery of Incentive*

The present and Senate proposed low rate and the Commons incentive are permanent, as the reduced corporate tax need never be repaid. The Commons report would impose a higher tax on dividend distribution because of the lower corporate tax. However, neither report suggested any offsetting capital gains provisions in recognition of their small business recommendations. In contrast, the Ontario Government proposes recovery of the small business tax credit.

If there is to be such recovery, an offset is necessary to avoid the serious effects which could occur with the 50 per cent tax rate applicable to the amount received on any disposal or withdrawal of the investment. For this reason, it is essential there be a rollover on reinvestment of the proceeds from the qualified investment, subject only to rules to prevent abuse. This would be a minimum, and a preferable approach would be broader rollover provisions.

In the case of smaller estates, the proposed recovery of the incentive at a rate of 50 per cent of the proceeds of the investment on which the incentive was claimed could prove too harsh. In such cases, it would be possible to provide, for example, that recovery be taxed at only 25 per cent as a deemed capital gain on death. The precise rules would depend upon decisions related to rollovers and estate exemptions.

### *3.10 One or More Incentives?*

It seems reasonably clear that if encouragement of owner-operators who are Canadian individuals is the prime purpose of the incentive, then the direct approach of a Canadian owner-operator investment incentive will provide the greatest impact as the primary incentive. If more is required, the way to achieve it is to moderate the limitation on the amount of incentive available. The possibility of additional incentives for specific purposes is discussed in Chapter 4.

### *3.11 Commencement of New System*

Careful consideration will be required on a number of administrative aspects if the new system is to run smoothly. The incentive is broadly conceived and should not be hemmed in by administrative limitations inappropriate to the social and economic objectives sought. Simple tests and methods for the vast majority of situations should only be complemented by more complex rules where this is essential to ensure reasonable fairness and compliance in certain special cases.

As previously stated, the Ontario Government believes the new system will have reasonable balance after it has been in effect for a period of time. Special rules, however, may be required in the transition period.

No investment by the owner-operator prior to the start-up of the new system would qualify for the proposed investment-related incentives. Thus, there would be no revenue losses referable to investments made under the present system when different taxing arrangements have prevailed, as only new investments would qualify.

During the first few years of the new incentive system it may be necessary, in order to avoid risk of manipulation, to exclude from qualifying any business investment made in a not-at-arm's length transaction. This would reduce any incentive to manipulate within family groups. It would be desirable in the future – perhaps after a determined transition period, probably five years – to drop such a restriction or make it significantly less restrictive.

The ability of heirs to use the incentive to assist in acquiring an existing small business from the estate of the deceased owner would help avoid unnecessary sell-outs of Canadian businesses based on the need for cash to pay estate and capital gains taxes arising on death. It would be undesirable to make it more difficult for a person active in a family business to acquire that business than to acquire a business with which he had no previous connection.

### 3.12 Some Examples

The following examples illustrate the workings of the credit and its recovery in the three basic types of owner-operator situation, and show the net advantage to the owner-operator compared with the present incentive.[5]

A. *A Sole Proprietor*

| | | |
|---|---|---|
| Investment during the year | | $ 3,000 |
| Business profits | | $ 7,000 |
| Other income | | 500 |
| Total income | | $ 7,500 |
| Tax payable, pre-credit | | $ 800 |
| Tax credit available, lesser of: | | |
| i) Annual limit | $10,000 | |
| ii) 50% of investment | 1,500 | |
| iii) 50% of pre-credit tax | 400 | 400 |
| Tax payable after credit | | $ 400 |
| Increased investment utilized for credit | | $ 800 |
| Adjusted cost basis of investment for determination of future capital gains tax or recovery of credit | | 2,200 |
| Increased investment carried back or forward | | 2,200 |

The credit would represent an incentive not available to the proprietor under the present system. In the case of a farmer it would be an additional incentive to investment over and above the continued use of the cash basis method of determining income enjoyed under the present system.

[5] The examples assume a married taxpayer with two dependent children.

B. *An Active Partner*

| | | |
|---|---|---|
| Acquisition of interest in partnership | | $15,000 |
| | Amount | Tax |
| Share of accrual basis profits | $15,000 | $3,100 |
| Share of cash basis profits (where applicable) | 10,000 | 1,500 |
| Tax credit available only if filing on an accrual basis, being the lesser of: | | |
| i) Annual limit | 10,000 | |
| ii) 50% of investment | 7,500 | |
| iii) 50% of pre-credit tax | 1,550 | 1,550 |

The credit would represent an incentive not available to a partner under the present system. The partner would have the option of filing on a cash basis (where he is entitled to do so as a farmer or professional) and paying $1,500 of current tax as under the present system or filing on an accrual basis, paying $1,550 in current tax and reducing the cost basis of his investment for capital gains tax and tax credit recovery purposes by $1,550.

C. *A Majority Shareholder*

| | | |
|---|---|---|
| Investment in corporation | | $30,000 |
| Profits of corporation before salary and tax | | $25,000 |
| Salary | | 25,000 |
| Corporate profit | | $ 0 |
| Personal tax, pre-credit | | $ 7,100 |
| Reinvestment in the corporation by way of further shares or debt | | 9,000 |
| Tax credit available being the lesser of: | | |
| i) Annual limit | $10,000 | |
| ii) 50% of investment ($30,000 + 9,000) | 19,500 | |
| iii) 50% of pre-credit tax | 3,550 | 3,550 |
| Increased investment utilized for tax credit | | 7,100 |
| Adjusted cost basis of investment | | 31,900 |
| Increased investment available for credit in subsequent years | | 31,900 |

- After personal tax of $3,550 and further investment in the company of $9,000, $12,450 is available for personal use.

- Under the present lower corporate rate system, the taxpayer would have somewhat less available for investment in the corporation if he drew a salary of $15,500 to provide him with after-tax personal funds of approximately $12,500. This would leave $9,500 of earnings to be taxed in the corporation for after-tax earnings of $7,300.

| | |
|---|---|
| • If he should sell his investment in the following year at the value shown in the books of the company he would realize . . . . . . . . . . . . . . . . . . . . | $39,000 |
| • which when compared with the adjusted cost basis of his investment of | 31,900 |
| • would give rise to a gain of . . . . . . . . . . . . . . . . . . . . . . | 7,100 |
| • and a tax (at 50%) of . . . . . . . . . . . . . . . . . . . . . . . . . | $ 3,550 |

- The $3,550 of tax credit would therefore be fully recovered.

# 4 OTHER MATTERS RELATED TO SMALL BUSINESS TAXATION

There are a number of other matters related to the taxation of small business which merit discussion in the context of the Ontario approach to the need for Canadian savings and investment and of the small business incentive proposed in this paper.

## *4.1 Farmers*

The federal white paper proposes retention of the cash method of reporting for farmers. Farmers who qualify as owner-operators (taxpayers who farm as a hobby would not meet the normal test of an owner-operator) should also have the option of taking advantage of the new small business incentive if it is to their advantage to do so. Traditionally, farmers have faced severe cash problems with almost all their assets tied up in fixed investment. If the new small business incentives and existing provisions relating to investments of farmers are not adequate to help farmers meet these cash problems, additional changes by way of faster write-offs or investment credits may prove desirable. The continued efficiency of Canadian farming will depend on the ability of Canadian farmers to finance even greater fixed investment in the future than in the past. This is an important priority which the reformed tax system must reflect.

## *4.2 Other Possible Incentives*

More specific incentives in selected areas may be possible and desirable in addition to the small business incentive. There are a number of possible devices which could be explored from time to time in relation to particular objectives, such as:

- a permanent carry-forward class of high technology or innovation expenditures similar to the mining exploration and pre-production expenditures;[1]

- a lower effective rate of tax;

- accelerated capital cost allowance, investment credit or deduction of 150 per cent of a qualified expenditure (such as the former scientific research tax incentive); and

- special treatment of stock options to key employees similar to principles of proposed small business incentive.

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[1] This would only be applicable in those cases where the present five-year limit for the carry-forward of business losses is insufficient.

In addition to Canadian owner-operators, there may be particular business activities – many of which will fall into the small business category – which it is especially desired to stimulate in order to achieve more selective objectives than the general one of encouraging small business. These might include businesses new to Canada, businesses new to a disadvantaged region in Canada, high technology businesses, heavy export-type businesses, or Canadian-identity businesses like books or films. In such cases both entrepreneurial capital and the passive investor might also benefit, with related benefits to Canadian small business.

In particular, additional encouragement may be needed for innovative small businesses. Such businesses are often better able to respond more quickly to market changes than a large corporation and, therefore, may be better placed to introduce and market an innovation, provided they are able to obtain sufficient capital. Many of the major innovations of the present century – penicillin, the jet engine, television, radar, the Polaroid camera, and xerography, for example – were the result of an individual's initiative and persistence in developing a market for a new product. We share the view of the U.S. Department of Commerce on this matter:

> From a number of different points of view, we are persuaded that a unique cost-benefit opportunity exists in the provision of incentives aimed at encouraging independent inventors, inventor-entrepreneurs, and small technologically-based businesses. The cost of special incentives to them is likely to be low. The benefits are likely to be high.[2]

### *4.3 Canadian Development Tax Incentive Plan*

Among many possible approaches is an adaptation of the owner-operator investment-related approach of the small business plan by establishing a Canadian development capital investment tax credit plan. This incentive could be aimed at Canadian individuals or intermediaries like mutual funds whose only holders were Canadian individuals. Businesses in which investment would qualify for the tax credit could be those whose ownership met similar tests to those now mandatory for banks, trust companies and broadcasting companies – that is, not more than 25 per cent ownership in the hands of non-residents.

This approach to Canadian development may be contrasted with a government corporation like the proposed Canada Development Corporation. This approach would decentralize investment decisions in the general areas identified for special incentive, as opposed to even more centralization in another government bureaucracy. It would be a positive approach to increased Canadian ownership by facilitating the investment itself by

[2] *Technological Innovation: Its Environment and Management*, (Washington: U.S. Department of Commerce, 1966).

individual Canadians in those areas where there is a special public interest in development by Canadians. It would involve no discrimination against non-residents in the same business, as all businesses would be taxed in the same way, regardless of their ownership. The approach is neither negative nor protectionist. It would do no more than make capital somewhat more accessible to Canadians in competition with non-residents, many of whom have significantly more capital to draw upon. It would be more efficient than the across-the-board decrease in the taxation of dividends which would result from both the full integration and half-integration proposals of the federal white paper. It would not be open to the charge made against the federal proposals that they were discriminatory in international investment.

There are many possibilities. The incentive could supplement the proposed tax credit for Canadian owner-operators. Or it could be an alternative, depending on how strong an incentive is desired. It could be structured to benefit Canadian individuals, while encouraging the pooling of savings in the hands of Canadian risk capital intermediaries. Of course, great care would need to be taken in choosing areas for the incentive, and its effectiveness would need to be reviewed to ensure the results merited the incentive.

### *4.4 Full Integration Benefits for Smaller Business*

At this point, given the views of the Senate and Commons Committees, and of the provincial governments, including the Ontario Government, it seems quite clear that full integration will not be a general feature of the reformed federal system. The Ontario position is that there should be no integration as such, and that any general incentive to invest in Canadian equity shares should be simple and direct (like the dividend tax credit), without resort to complex procedures or theories about who really pays the corporate tax. Nonetheless, the *Ontario Proposals* expressed belief in the possibility that some new approaches were possible in dealing with those smaller companies which are similar to unincorporated proprietorships and partnerships.[3]

The Commons Committee did recommend that a partnership option be available for small closely-held corporations (a distinction the Commons Committee would keep for this purpose and for small business relief) and full integration for the first $50,000 of annual taxable income for Canadian closely-held corporations controlled by Canadian residents. This type of integration would benefit passive investors as well as owner-operators and, unless restricted, could result in a greater than $50,000 cumulative benefit to an individual investor in several closely-held corporations. These effects do not seem necessary or desirable.

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[3] *Ontario Proposals, op. cit.*, page 23.

### *4.5 Alternative to Commons Committee Proposal*

An alternative approach consistent with the thinking of the Commons Committee but more in keeping with the owner-operator type of incentive would be to make integration a privilege of individual Canadian owner-operator shareholders, rather than relate it to a type of corporation. The reason for some measure of full integration is to try to equalize the tax position of the small incorporated business with the small proprietorship or partnership. This argument has merit when considering the owner-operator shareholder of a corporation but has little or no merit when considering the passive investor in that corporation. This equalization is not as important an objective for the Ontario Government as it seemed to be for the federal government in its white paper. This is because incorporation is not difficult, and, if the cash method were continued for professionals, who sometimes cannot incorporate, there would be little practical reason for concern about different treatment between incorporated and unincorporated business by reason of a tax on dividends. On the other hand, practical integration can and will be achieved for owner-operators to the full extent of justified salaries. Beyond that, it seems reasonable for owner-operators, in their role as investors, to be taxed on dividend distributions on the same basis as any other investor – that is, taxed on dividends subject to a general dividend tax credit.

The alternative approach would rest on three principles:

- for personal business income of up to say $50,000 a year, there is validity in the feeling there should be little tax difference between an incorporated and an unincorporated business;

- business income that really reflects personal services should be taxed on essentially the same basis as all personal income, namely at personal rates, and not be subject to two taxes, once in the corporation and once in the hands of the individual shareholder. When business income climbs beyond the personal service element, all corporate business income should be taxed alike – once in the corporation and once in the hands of the shareholder subject to dividend tax credit to Canadian resident individual shareholders; and

- all corporations should be treated the same, and any incentive relief should be to individual Canadian shareholders only.

The tests for qualification could be identical to the owner-operator qualifications required for the proposed small business incentive. Possible techniques would include any one or all of the following:

- a "safe-haven" salary approach. Any individual taxpayer qualifying as an owner-operator could take out say $50,000 as salary – thus a deduction from company income – and no question of justification of the propriety of salary would be raised. This would be $50,000 aggregate of all salaries and business income of a particular owner-operator. On the other hand, larger salaries could be permitted where justifiable as a reasonable business expense;

- a partnership election by the individual owner-operator whereby up to $50,000 of business income and salary is deemed his income and salary and credit for corporate tax paid on appropriate portion is allowed. Again, the maximum limit would be $50,000 of all such business income and salary from all sources; and

- a personal integration right of up to $50,000 (minus salaries and other business incomes) in respect of actual dividends received from all companies in which the taxpayer is an owner-operator.

The practical effect of this approach would be that a qualifying taxpayer could elect to be taxed at personal rates only on annual income up to $50,000. Beyond that, he would have to receive and justify a higher salary as reasonable, or would be subject to tax on dividend distributions on the same basis as other investors.

### *4.6 Cash Method of Reporting Income*

The present system permits a professional or a farmer to report his income on a cash basis. The white paper proposed its withdrawal for the professional, the Senate Committee recommended retention, and the Commons Committee recommended a mid-position. However, as these taxpayers are themselves owner-operators, they would be able to take advantage of the proposed incentive. Certainly, it would be inconsistent to offer special taxing arrangements to small business to replace the present low rate, and not recognize the parallel to the professionals, whom the federal white paper proposed to tax on money they have not yet received.

In effect, the present cash basis for most professionals is not as favourable as the present lower rate of tax, for two reasons. First, it is unlikely that $10,000 annual tax will be deferred each year, year after year, as is the case with the lower rate. Second, there is almost always a day of reckoning when the receivables and work in process are recovered at the end of the road. Even the present cash basis for most professionals would not be as favourable as an annual $10,000, lifetime $100,000, tax credit for smaller business. Very few, if any, individual professionals would reach a position of having $200,000 of untaxed accounts receivable and inventory on hand at any one time. Yet the cash basis is an extremely simple method that puts self-employed professionals on the same tax basis as employed professionals, and on a similar basis to small corporations. Many professionals do

not have substantial investment in other than accounts receivable and inventory, which are fully taken care of by the cash method. These considerations argue for retention of the present cash method, which would maintain rough equivalence between professionals and those able to take advantage of the proposed small business incentive. It would be possible to give professionals the right to elect to go on an accrual basis and take the small business incentive instead if this seemed desirable. This approach would eliminate any question of advantage or disadvantage between professionals who cannot incorporate and those businessmen who are able to incorporate and who would be able to get the proposed new small business incentive.

# 5 SAVINGS AND INVESTMENT

The Ontario approach reflects greater concern than the federal proposals about the general savings and investment effects of tax reform on economic growth. The small business incentive proposed in this paper reflects this concern and is intended to operate as part of the general reformed system advanced in the *Ontario Proposals.* This Chapter explores the Ontario system, partly in relation to the tax system comparison contained in Chapter 2, and partly in relation to the small business incentive proposed in Chapter 3.

As a first stage, the Ontario approach is to modify the existing tax structure affecting business and investments in two main ways. First, Ontario's proposed rate schedule reduces the top rate to 65 per cent.[1] The Ontario decision to keep the top rate significantly above 50 per cent and to reject the integration proposals has the merit of reducing the tendency to move to the personal rate structure implicit in the federal white paper. Second, changes in the taxation of corporations and shareholders would eliminate loopholes and increase the dividend tax credit slightly to the benefit of low and middle-income groups. It would then introduce a moderate but fully separate capital gains tax and reduce estate taxation in order to achieve a level of capital taxation which will not reduce savings or discourage enterprise in the creation and expansion of business by Canadians.

## *5.1 Federal White Paper Impact*

If the federal white paper proposals of a top 50 per cent rate were adopted, there would be a powerful tendency for business to seek access to the personal rate structure in order to avoid any double taxation of corporate source income inherent in the federal integration proposals. This would not only create business distortions and revenue losses, but would largely eliminate the tendency of the present system to encourage earnings retention for business growth. When added to the heavier taxation of capital of the federal approach, there would be a significant shift in the balance of influences towards consumption and away from savings. The Ontario Government's view is that small business cannot hope to thrive in such a climate.

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[1] This contrasts with the federal white paper and Senate Committee proposals of a top rate of 50 per cent and the Commons Committee proposals of a top rate of 60 per cent. See, *Ontario Proposals, op. cit.,* page 20; and Staff Paper, *Effects of Ontario's Personal Income Tax Proposals.* Ontario Studies in Tax Reform 2, (Toronto: Department of Treasury and Economics, December, 1970), page 18.

### *5.2 Capital Gains*

The Ontario Government's approach to capital gains taxation is generally less severe than the federal proposals on all capital gains except short term gains and gains of traders in shares of Canadian widely-held companies[2] and those in the hands of well-to-do individuals from their shares in mature non-growth private companies.[3] However, unlike the present system in relation to corporate surplus, and the federal white paper proposals in relation to capital gains on death, the Ontario proposals for deemed realization of capital gains at death and reduced estate taxation face squarely the issue of the appropriate level of all capital taxation at death.

### *5.3 Rollovers*

Any form of capital gains taxation based on the realization principle, as proposed by the Ontario Government, may impede economically desirable transfers. The *Ontario Proposals* recognized this and called for provisions to facilitate necessary and desirable changes in the ownership of capital assets. They also recognized general problems of economic efficiency and expressed a willingness to consider variations in the general framework which would assist in their solution.

The basic solution to these problems lies in appropriate rollover provisions. One approach is to restrict rollovers stringently, in which case many economically desirable transfers are almost certain to be impeded. This was the approach of the federal white paper, except the almost unanimously disapproved five-year revaluation proposal was regarded as a sufficient protection to allow broad tax-free rollovers in the case of widely-held shares. Another solution is to widen the rollover provisions in which case many normal decisions will be distorted in order to get under the umbrella of the tax-free rollover. This is basically the United States approach. This has led to takeovers and mergers in which an exchange of shares takes the place of cash payment, with results that are not always satisfactory.

The Ontario proposals do not take a specific position on rollovers, but leave the matter open for discussion. Ontario favours the broadest possible rollovers to minimize taxation as an influence in investment decisions. One alternative, as it affects small business, is to permit a rollover on any sale of shares by an owner-operator in a small business, or of the small business itself, provided the proceeds are reinvested. This would completely eliminate any tax impediment to going public or merging or selling-out to a larger company. Any such

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[2] The Ontario proposals would tax these gains up to 65 per cent as income, whereas the top rate under the federal proposals would be 25 per cent.

[3] If the only gains reflected retained earnings, there would normally be no tax under the federal proposals, but a 25 per cent capital gains tax would be payable under the Ontario proposals.

decision could then be based solely on considerations of economic merit, which would eliminate the type of distortion that occurs under the United States system of tax-free share exchanges.

If a broader rollover than in the United States seems desirable for small business, the next question is whether it would be sound to exclude real assets and public company shares from a reinvestment rollover approach. There is no question that the need for both private savings in Canadian hands and capital market efficiency strongly favours a reinvestment-related tax-free rollover approach for all shares and business assets. With deemed realization on death, an important equity argument against the approach is substantially lightened, especially if one regards the taxation of capital as more appropriately having a lifetime perspective, in comparison with the taxation of income or consumption, which may more appropriately be on a current basis.

### *5.4 Long-Term Structure*

The Ontario proposals are based on the central importance of savings and investment for economic growth as the only reliable generator of increased revenues to governments. Thus, the Ontario Government does not believe in designing a long-term structure on the basis of short-run revenue considerations. For any rollover will only delay the collection until the gain is realized in spendable form or the taxpayer leaves the country or dies. Nonetheless, the question arises as to the likely revenue impact of granting wide rollover privileges during the lifetime of the taxpayer based on reinvestment. It seems unlikely to be great. Full taxation of short-term and trading gains and taxation of gains realized in spendable form would be unaffected. So would the deemed realization of gains on death. Moreover, the Ontario gains base would be higher than under the federal proposals, because it would include accrued gains on death and retained earnings. Also, the Ontario proposed dividend tax credit would be less generous to high-income taxpayers than either the federal proposal for full integration for closely-held corporations and half-integration for Canadian widely-held corporations, or the half-integration proposal for all Canadian corporations advanced by the Commons Committee.

It is important to note that the Ontario Government expects an annual net revenue gain of only $100 million from the combined taxation of estates and capital gains as a result of its national tax reform package.[4] As some capital gains would, in any event, be used for consumption, not reinvestment, any adverse general impact on Canadian savings should be moderate and acceptable. A general reinvestment-related rollover would further favour savings over consumption. In assessing this net revenue gain, it is to be noted that the integration revenue losses proposed by the federal white paper were regarded as unnecessary

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[4]*Ontario Proposals, op. cit.*, page 45.

and undesirable by the Ontario Government. Under the *Ontario Proposals,* the revenue expected from capital gains would not, as under the federal white paper, be offset by reduced revenues from what the Ontario Government regards as an unnecessarily generous reduction in the taxation of current dividends and other corporate distributions.

### *5.5 Encouragement to Canadians*

The Ontario approach seeks fairness and moderate revenue gains from introducing a capital gains tax, without requiring damage to savings or investment in general or to the dynamics of Canadian small business in particular. They reflect fully the view that a dynamic economy is the only source of lasting revenue gains that are compatible with bearable tax levels. While the Ontario capital gains and related estate tax reduction proposals have not been presented in full detail, the views expressed in this chapter point the way to a reformed tax system which, with the addition of a sound incentive to small business, would effectively encourage investment by Canadians in the economy of their country.

# 6 CONCLUSION

The Ontario Government is satisfied that its proposals relating to savings and investment and the taxation of corporations and shareholders constitute the best basis for sound and workable tax reform which will contribute to the efficient growth of the Canadian economy.

The Ontario Government has proposed a novel small business incentive to replace the present dual rate of corporate tax. The proposal reflects Ontario's conviction that broad social and economic benefits can flow from encouraging Canadians to own and expand their own businesses. The focus on the individual Canadian owner-operator as the person to get the incentive constitutes a powerful long-term encouragement to the development of the Canadian economy by Canadians.

The Canadian economy will continue to need foreign capital for its efficient development. The Ontario approach to the taxation of business and investment is based on facilitating capital investment by Canadians, without any discrimination against international business investment. This is important in the face of a world shortage of capital and developing protectionism in many countries. Canada has a major stake in reasonably free international trade and capital movements. For this reason, Canadian tax policies should not be inward-looking.

Most important of all, the Ontario Government hopes that the approach and proposals of this paper will be carefully considered by the federal government. Ontario is fully prepared to discuss these proposals at both the ministerial and official levels.

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